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**Loopholes Provide Activist Securityholders Unfair Advantages in Takeover Contests; How Targets Can Fight Back ¶15.1]**

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During 2008 high profile takeover proxy contests have involved activists that successfully exploited gaps in disclosure rules and company by-laws. This year three companies suffered public battles from hedge funds that circumvented federal securities regulation reporting requirements and advance notice provisions informed by state law. In *CSX v. Children's Fund Mgmt. (UK) LLP*,<sup>1</sup> the Federal District Court for the Southern District of New York facilitated securityholder efforts to elect dissident directors in finding that the failure of hedge funds to

disclose derivative positions, although in violation of Securities and Exchange Commission ("SEC") regulations, did not violate advance notice provisions. In two other cases, *Jana Master Fund, Ltd. v. CNET Networks, Inc.*<sup>2</sup> and *Levitt Corp. v. Office Depot, Inc.*,<sup>3</sup> the Delaware Chancery Court interpreted common advance notice provision language in favor of activist securityholders resulting in the nomination of director candidates proposed by such activists. These cases depict increasingly widespread practices employed by activist securityholders from which many target companies are not protected.

***CSX Corp. v. Children's Investment Fund Mgmt.***

In *CSX*, the Federal District Court for the Southern District of New York ruled that two hedge funds violated SEC regulations in connection with advance notice and disclosure requirements for stockholder nominations and proposals. The hedge funds, The Children's Investment Fund ("TCI") and 3G, targeted the railroad company CSX Corp., a Virginia corporation,

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for replacement of its Board.<sup>4</sup> Initially, the hedge funds acquired derivative interest agreements, known as “total return swaps,” with several banks, and then approached CSX Board members with their demands. Both hedge funds purposefully distributed their derivative interests, never exceeding 5% of CSX ownership at any one institution,<sup>5</sup> to avoid SEC reporting requirements.<sup>6</sup> When the CSX Board of Directors dismissed their demands, the hedge funds consolidated their derivatives and purchased stock. After making the required SEC disclosures, the funds prepared to make a shareholder proposal and to wage a proxy fight to replace two members of the CSX Board.<sup>7</sup>

CSX filed suit to enjoin the funds from voting any shares acquired during the period between when the funds should have made the SEC disclosures and when the funds actually made such disclosures.<sup>8</sup> CSX argued that the hedge funds’ derivative interest in CSX stock constituted “beneficial ownership” under the SEC regulations, and therefore, the funds should have reported their ownership interests.<sup>9</sup>

The court ruled in favor of CSX, even though it found that derivative instruments do not constitute beneficial ownership per se.<sup>10</sup> The court reasoned that the funds were beneficial owners because they purposefully designed their investment strategy with the intent to avoid SEC reporting requirements.<sup>11</sup> Thus, the funds were required to disclose their derivative interests to the SEC and to CSX’s stockholders. Nevertheless, the court found that the funds’ failure to disclose derivative interests in their proxy statements *did not* violate CSX’s By-Laws, whose definition of “beneficial ownership” was not broad enough to compel disclosure of total return swaps.<sup>12</sup>

### *Jana Master Fund Ltd. v. CNET Networks, Inc.*

In *CNET*, the hedge fund Jana attempted a take-over of the CNET Board by nominating director candidates and increasing the size of CNET’s Board.<sup>13</sup> Jana notified CNET that it intended to undertake a self-financed proxy solicitation for its proposals.<sup>14</sup> CNET filed suit to prevent Jana from presenting its proposals. CNET argued that Jana did not comply with its By-Laws’ advance notice provision, which required a stockholder to have held \$1,000 worth of stock for a full year before the stockholder could properly “seek to transact other corporate business at the annual meeting.” According to CNET, Jana would have owned CNET stock for only eight months as of the annual meeting date.<sup>15</sup>

The Delaware Chancery Court found that CNET’s advance notice provision did not prevent Jana from independently challenging corporate elections because the advance notice provision, as drafted, was limited in scope to Rule 14a-8 stockholder proposals.<sup>16</sup> The court offered three rationales for its decision. First, the court found that by-law language providing that a stockholder “may seek” to bring proposals evidenced an intent that the advance notice provision governed only Rule 14a-8 stockholder proposals.<sup>17</sup> Second, the court maintained that the advance notice provision should apply only to proxy statement proposals given that the provision’s deadline for submitting proposals explicitly referenced the proxy statement mailing deadline.<sup>18</sup> Finally, the court found that the advance notice provision was limited in scope to Rule 14a-8 stockholder proxy proposals by the language requiring the notice to comply with “any applicable federal securities laws governing shareholder proposals a corporation must include in its own

proxy materials.”<sup>19</sup> On May 13, 2008, in a one-page memorandum decision, the Delaware Supreme Court affirmed the Court of Chancery’s decision.<sup>20</sup>

***Levitt Corp. v. Office Depot, Inc.***

*Office Depot* also involved a stockholder’s attempted nomination of director candidates at an annual meeting. After Office Depot filed its definitive proxy materials with the SEC, Levitt Corp., an owner of more than 3,000,000 shares of Office Depot common stock, filed its own proxy materials without notifying Office Depot that it intended to nominate its own director candidates.<sup>21</sup> Almost simultaneously, Levitt also sued Office Depot in Delaware Chancery Court to ensure that its nominations did not require additional notice.<sup>22</sup> Office Depot argued that its By-Laws required advance notice of stockholder nominations to be properly brought before the meeting. Levitt countered that the By-Laws did not require advance notice of director nominations, and that even if they did, Office Depot fulfilled the requirement by making director nominations an item of business in its own notice of the meeting.<sup>23</sup> Levitt also argued that the By-Laws’ 120-day notice requirement was an unreasonable restriction of stockholder rights.<sup>24</sup>

On April 14, 2008, the Chancery Court ruled that proper notice of the Office Depot Board elections was given, and therefore, the Office Depot By-Laws did not bar Levitt from nominating competing candidates at the annual stockholder meeting.<sup>25</sup> The court found that nominating and electing Board members constituted “business” within the meaning of Office Depot’s By-Laws, and that advance notice of such proposals was required.<sup>26</sup> However, the court noted that the company itself satisfied this requirement in its notice of meeting.<sup>27</sup> The court rejected Office Depot’s contention

that its notice of meeting only proposed approving or rejecting its slate of directors as a whole. Instead, the court found that the notice included both the company’s nominees and the competing slate.

***Activist Practices: Coordinated Efforts and Derivative Securities***

These cases highlight the increased use of two practices by activist securityholders. First, it is now common for multiple hedge funds to invest in the same target; activist funds believe that their collective activities will yield desired results. Although federal securities laws do not prohibit securityholders from communicating with one another regarding their investments in a target, securityholders are required to report to the SEC if and when they beneficially own in the aggregate more than 5% of the target’s securities when they have entered into a relationship, understanding, arrangement or contract regarding their investments.<sup>28</sup> The goal of these rules is to alert the marketplace to any incipient control contest. At least until it filed its *amicus curiae* brief to the CSX court earlier this month,<sup>29</sup> the SEC had generally defined “beneficial ownership” broadly. Unfortunately, as a result of evidentiary issues, the SEC and courts rarely find that coordinated action of activist shareholders violates this “group” reporting requirement under Section 13(d) of the Securities Exchange Act of 1934.

Second, activist securityholders are more frequently purchasing derivative instruments, such as hedges and swaps connected to the target’s voting stock. In its *amicus curiae* brief to the CSX court, the SEC suggested that total return equity swaps are not subject to beneficial ownership reporting requirements.<sup>30</sup> Combined with the feature that such swaps allow activist securityholders to leverage and increase potential

returns in targets, these instruments now allow activist alliances to exist virtually undetected.

### *Targets Fight Back*

Public companies can fight back in response to this jurisprudence and coordinated actions by activist shareholders that accumulate positions in swaps and hedges.

Several companies have recently amended their by-laws in order to deal with these issues.<sup>31</sup> The amendments close the advance notice loophole by requiring securityholders to fully disclose their positions and relationships when making nominations and proposals. Requiring full disclosure limits a hedge fund's ability to operate beyond the by-laws and SEC regulations, making a company a much less inviting target.

For example, this spring, both Coach, Inc. and Sara Lee Corp. amended their advance notice provisions, broadening the required disclosures.<sup>32</sup> The changes made to each company's by-laws are nearly identical.

First, both companies added provisions that require securityholders, when making a nomination or proposal, to disclose any hedges or transactions designed either (1) to manage or mitigate the securityholder's risk or benefit or (2) to increase or decrease securityholder's voting power.<sup>33</sup> Such language prevents activist hedge funds from over- or under-representing their interests in the corporation when making nominations or proposals.

Second, both companies added broad definitions of "Stockholder Associated Person," and required SAPs to also disclose their positions.<sup>34</sup> Such amended by-laws define a SAP as any person or entity that collaborates with any shareholder, or any beneficial owner of stock whose owner of record is the shareholder,

or any other person controlling, controlled by or under common control with a SAP.<sup>35</sup>

This provision compels disclosure of combinations so that targets can become more aware of combinations and arrangements behind a nomination or proposal. Without being required to disclose such interests pursuant to this expanded concept, a hedge fund can gain a powerful advantage in a proxy contest by designing its investments to avoid full disclosure.

Additionally, Coach moved its annual meeting advance notice window further out from the anniversary of the mailing of the previous year's proxy statements: from a 90 to 120 day window before the anniversary to a 120-150 day window before the anniversary.<sup>36</sup> Requiring notice another month before the annual meeting discourages short-term investors from targeting the company, and increases a company's opportunity to stave off a hedge fund takeover.

Both Coach and Sara Lee clearly stated that, notwithstanding the companies' amended advance notice provisions, stockholders must still comply with all applicable state and federal laws governing stockholder proposals and director nominations.<sup>37</sup> Both companies also expressly reserved their right to omit a stockholder proposal pursuant to Rule 14a-8, regardless of whether that proposal complies with the by-laws' advance notice provisions.<sup>38</sup>

### *Conclusion*

Based on the foregoing cases, we recommend that companies consider amending their by-laws in the following manners: (1) broaden the provisions to ensure the fullest possible disclosure of securityholder interests; (2) insert provisions requiring all proposals and nominations, whether stockholder-funded or included in the proxy materials, to comply with the by-laws as well as state

and federal law; and (3) insert a broad definition of “beneficial ownership” to include all swaps, hedges, and other derivative instruments, in order to compel the fullest possible disclosure of security-holder interests.

Finally, companies should revise their notice to stockholders of the annual meeting to specify that the agenda item on director elections applies only to the election of director candidates described in the Proxy Statement, not to nominations generally. Wal-Mart Stores, Inc. has revised its Notice in this manner.<sup>39</sup> Specifically, this Notice item should read: “Elect as directors the nominees named in the attached proxy statement.”

1. *CSX Corp. v. Children’s Investment Fund Mgmt. (UK) LLP*, 08 Civ. 2764 (S.D.N.Y. 6-11-2008).
2. *Jana Master Fund, Ltd. v. CNET Networks, Inc.*, 3447-CC (Del.Ch. 3-13-2008).
3. *Levitt Corp. v. Office Depot, Inc.*, 3622-VCN (Del.Ch. 4-14-2008).
4. *CSX Corp. v. Children’s Investment Fund Mgmt. (UK) LLP*, 08 Civ. 2764, 13 (S.D.N.Y. 6-11-2008).
5. The Williams Act, 15 U.S.C. §79m.
6. *Id.* at 65.
7. *CSX Corp.* at 40.
8. *Id.* at 5.
9. *Id.* at 45.
10. *CSX Corp.* at 64.
11. *Id.* at 72.
12. *Id.* at 89.
13. *Jana Master Fund, Ltd. v. CNET Networks, Inc.*, 3447-CC, 1 (Del.Ch. 3-13-2008).
14. *Id.* at 2.
15. *Id.*
16. *Jana Master Fund, Ltd.* at 19.
17. *Id.* at 8. The court referenced SEC Rule 14a-8, 17 C.F.R. §240.14a-8, which promulgates procedures for stockholders to include their proposals in corporate proxy statements.
18. *Jana Master Fund, Ltd.* at 15.
19. *Id.* at 16.
20. *CNET Networks, Inc. v. Jana Master Fund, Ltd.* C.A. No. 3447-CC, 1 (Del. 5-13-2008).
21. *Levitt Corp.* at 3.
22. *Id.* at 1.
23. *Id.* at 6.
24. *Id.*
25. *Id.* at 18.
26. *Levitt Corp.* at 13.
27. *Id.* at 17.
28. 17 C.F.R. §240.13(d)-3(a) (2008).
29. Brief of Amici Curiae, Int’l Swaps and Derivatives Ass’n and Sec. Indus. and Fin. Mkts Ass’n, *CSX Corp. v. Children’s Investment Fund Mgmt. (UK) LLP*, 08 Civ. 2764, 64 (S.D.N.Y. 6-11-2008).
30. *Id.* at 14-16.
31. *See* Coach, Inc., Current Report (Form 8-K), (Feb. 7, 2008); Redwood Trust, Inc. Current Report (Form 8-K), (March 5, 2008); HRPT Properties Trust, Current Report (Form 8-K), (March 5, 2008); Sara Lee Corp., Current Report (Form 8-K), (March 27, 2008); Five Star Quality Care, Inc., Current Report (Form 8-K), (March 28, 2008).
32. *See* Coach, Inc., Current Report (Form 8-K), (Feb. 7, 2008); Sara Lee Corp., Current Report (Form 8-K), (March 27, 2008).
33. *See* Coach, Inc., Current Report (Form 8-K), at 3 (Feb. 7, 2008) (See Article 2, Section 12 (a)(2)); Sara Lee Corp., Current Report (Form 8-K), at 2 (March 27, 2008) (See Article I, Section 10(a)(2)).
34. *Id.*
35. *Id.* *See also* Coach, Inc., Current Report (Form 8-K), at 3 (Feb. 7, 2008) (See Article 2, Section 12(a)(4)); Sara Lee Corp., Current Report (Form 8-K), (March 27, 2008) (See Article I, Section 10(a)(4)).

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| 36. Coach, Inc., Current Report (Form 8-K), at 3 (Feb. 7, 2008) (See Article 2, Section 12(a)(2)).                                | (Form 8-K), (March 27, 2008) (See Article I, Section 10(c)(4)).  |
| 37. Coach, Inc., Current Report (Form 8-K), at 3 (Feb. 7, 2008) (See Article 2, Section 12(c)(4)); Sara Lee Corp., Current Report | 38. <i>Id.</i><br>39. See Wal-Mart Stores, Inc. Notice of Annual Shareholders' Meeting dated April 22, 2008. |

## OTHER CORPORATE DEVELOPMENTS

**[¶15.2] Demand futility—Conn.—** Demand will be excused where a majority of a corporation's directors are not disinterested or independent as a result of having divided loyalties to other companies.

Michael Christiani and CPTR, LLC (CPTR), a company entirely owned by Christiani and his wife, invested around \$700,000 in BenefitCard Systems, Inc. (BenefitCard), a start-up company. John Randazzo, BenefitCard's CEO, president, treasurer, and, initially, sole director, made multiple fraudulent representations to Christiani that induced him to make the investment. Randazzo subsequently became the president and treasurer of BenefitPoint, Inc. (BenefitPoint), an alleged affiliate of BenefitCard. Eventually, the relationship between Christiani and BenefitCard soured, and the company went out of business. By that point, BenefitCard had four directors, two of whom were also BenefitPoint officers or directors. Christiani brought suit against Randazzo and BenefitCard's board of directors, for fraud, breach of fiduciary duty, violation of the Connecticut Uniform Securities Act, conversion, negligent misrepresentation, innocent misrepresentation, violation of the Connecticut Unfair Trade Practices Act (CUTPA), and civil conspiracy. The defendants moved to dismiss, arguing, *inter alia*, that because the breach of fiduciary claim was being pursued in a derivative action, and no pre-suit demand was made upon BenefitCard, the court lacked subject matter jurisdiction. Christiani responded by asserting that a pre-suit demand was not required as it was unnecessary, impossible or would have been futile.

Applying Delaware law (since BenefitCard was incorporated in Delaware), the Connecticut Superior Court denied the defendants' motion to dismiss. The court recited the Delaware rule that demand can only be excused where facts are alleged with particularity that create a reasonable doubt that the directors' action was entitled to the protections of the business judgment rule. One of the ways demand can be shown to be futile is by pleading particularized facts that create a reasonable doubt that the directors were disinterested and independent. Here, the court concluded that Christiani had pleaded throughout the complaint that a majority of the directors were not disinterested or independent, but instead had divided loyalties and directorial interest. Directorial interest exists whenever divided loyalties are present, or a director either has received, or is entitled to receive, a personal financial benefit from the challenged transaction which is not equally shared by the shareholders. Specifically, Christiani had alleged that Randazzo and another director, as officers and directors of both BenefitPoint and BenefitCard, continuously misrepresented, among other things, that BenefitCard and BenefitPoint were affiliated businesses; that BenefitPoint was committed to the success of BenefitCard; and that BenefitPoint would generate substantial revenues for BenefitCard. Randazzo had been a director and even chairman, as well as, at various times, the CEO, president and treasurer of BenefitCard. Another director also served

as BenefitPoint's CEO. Still another director was the CEO of a company that through BenefitCard received a substantial amount of Christiani's money. For these reasons, the court held that a majority of the directors was not disinterested and that demand would have been futile [*Christiani v. BenefitPoint, Inc.*, 2008 Conn. Super. LEXIS 528 (Conn. Super. Ct. 2008); ¶84,997.83].

**Statutory short-form merger; fiduciary duties—Del.**—The directors of a corporation seeking to effect a statutory short-form merger breach their fiduciary duties of disclosure by failing to attach to the notice of minority shareholders' appraisal rights a copy of the state's current appraisal statute and by failing to disclose all material information. A remedy for such breach is a "quasi-appraisal" remedy.

Pubco Corporation provided notice to its minority shareholders that the corporation was effecting a short-form merger and that the minority shareholders were being cashed out at \$20 per share. The controlling shareholder and sole director was Robert Kanner. The notice, however, was not accompanied by a copy of the state's current appraisal statute, as statutorily required. Moreover, the notice was not very detailed and failed to disclose various company finances. It also did not disclose how Kanner had determined the price at which he set the merger consideration. One of Pubco's minority shareholders, Barbara Berger, brought suit, purportedly as a class action, claiming that the class was entitled to receive the difference between the merger consideration and the fair value of the company's shares, regardless of whether or not any individual class member had demanded appraisal.

The Delaware Court of Chancery started its analysis by observing that in the context of a short-form merger, shareholders do not need to cast an informed vote on whether or not to effect the merger

itself. Instead, where the only choice for minority shareholders is whether to accept the merger consideration or seek appraisal, they must be given all of the factual information that is material to *that* decision. Importantly, the parent does not need to provide *all* the information necessary for the stockholder to reach an independent determination of fair value; only that information material to the decision of whether or not to seek appraisal is required. Here, the court determined that Pubco's failure to attach a current version of the appraisal statute was a statutory violation. It also rejected Kanner's argument that because he was not obligated to set a fair price, he was not required to disclose how he arrived at the merger consideration. Instead, the court concluded that information as to how Kanner had arrived at the merger price was material, as it would alter the total mix of information available to minority shareholders. The court said, "Where, as here, a minority shareholder needs to decide only whether to accept the merger consideration or to seek appraisal, the question is partially one of trust: can the minority shareholder trust that the price offered is good enough, or does it likely undervalue the Company so significantly that appraisal is a worthwhile endeavor?" Thus, while Kanner did not have to reveal picayune details about the process he used to set the price, he should have disclosed in a broad sense what that process was. Finally, the court ruled that because the disclosure violation resulted in an irreparable injury, the appropriate remedy was "quasi-appraisal." Under this remedy, Pubco would be required to make supplemental disclosures to address its disclosure violations, and minority shareholders would be given an opportunity to choose whether to participate in an appraisal proceeding. Those shareholders choosing to opt-in would be required to place a certain amount in

escrow to account for the risk that the court would appraise Pubco at less than \$20 per share. Finally, Pubco would be valued as of the date of the merger using

the method prescribed by the appraisal statute [*Berger v. Pubco Corp.*, 2008 Del. Ch. LEXIS 63 (Del. Ch. Ct. 2008); ¶84,997.84].

## LEGISLATIVE NEWS

¶15.3] Here is a list of statutes appearing in this report that have been amended or added.

### DELAWARE

#### *GCL amended*

391 Taxes and fees payable to secretary of state upon filing certificate or other paper

#### *Corporation Franchise Tax amended*

503 Rates and computation of franchise tax

#### *LLC Act amended*

18-101 Definitions  
18-110 Contested matters relating to managers; contested votes  
18-111 Interpretation and enforcement of limited liability company agreement  
18-204 Execution  
18-212 Domestication of non-United States entities  
18-214 Conversion of certain entities to a limited liability company  
18-1107 Taxation of limited liability companies

#### *Statutory Trusts amended*

T. 12, 3813 Fees  
T. 12, 3862 Fees

#### *Code amended*

T. 12, 1198 Definitions

### INDIANA

#### *Takeover Offers amended*

23-2-3.1-1 Definitions  
23-2-3.1-4 Statement; consent to service of process; filing fee  
23-2-3.1-9 Administration of chapter; regulations; immunity

### NEW HAMPSHIRE

#### *RS added*

491:7-a Business and commercial dispute docket

### NEW YORK

#### *BCL amended*

104-A Fees  
904-a Merger or consolidation of corporations with other business entities; certificate of merger or consolidation

#### *LLC Law amended*

1003 Certificate of merger or consolidation; contents

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